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## STATEMENT OF DISCIPLINARY ACTION

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### The Disciplinary Actions

1. The Securities and Futures Commission (**SFC**) has reprimanded and fined China Merchants Securities (HK) Co., Limited<sup>1</sup> (**CMS**) \$27 million<sup>2</sup>, pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken according to an agreement pursuant to section 201 of the SFO dated 24 May 2019 in relation to CMS's failures in discharging its duties as one of the joint sponsors in relation to the listing application of China Metal Recycling (Holdings) Limited (**China Metal**).
3. The SFC's disciplinary action against CMS followed its earlier sanction against UBS AG<sup>3</sup> and UBS Securities Hong Kong Limited<sup>4</sup> (**UBS Securities Hong Kong**) (collectively **UBS**) for its failures in relation to the listing application of China Metal and two other companies<sup>5</sup>.
4. The SFC's investigation revealed that CMS and UBS had respectively failed in their due diligence as joint sponsors to address a number of unusual facts and findings on China Metal and its customers during the listing process.

### Regulatory requirements<sup>6</sup>

5. A sponsor is required to conduct reasonable due diligence inquiries so as to put itself into a position to ensure that the disclosure in the listing document and all information provided to the Stock Exchange of Hong Kong (**SEHK**) during the listing application process are true in all material respects and do not omit any material information.
6. Specifically, a sponsor is required by:
  - (a) General Principle 2 (diligence) of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) and paragraph 5.1 (due skill and care) of the Corporate Finance Adviser Code of Conduct (**CFA Code of Conduct**) to act with due skill, care and

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<sup>1</sup> CMS is licensed under the SFO to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 9 (asset management) regulated activities.

<sup>2</sup> The SFC has also suspended the licence of Wu Yinong, sponsor principal in charge of the supervision of China Metal's listing application for CMS, for 18 months. See the SFC's press release on Wu dated 27 February 2019.

<sup>3</sup> UBS AG is licensed under the SFO to carry on Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance), Type 7 (providing automated trading services) and Type 9 (asset management) regulated activities.

<sup>4</sup> UBS Securities Hong Kong is licensed to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities under the SFO. With effect from 7 June 2012, a part of the Type 6 regulated activity carried on by UBS AG, namely, acting as sponsor in respect of an application for the listing of securities, was assumed by UBS Securities Hong Kong.

<sup>5</sup> See the SFC's press release on UBS dated 14 March 2019 regarding the SFC's findings on UBS's failures in the other two listing applications.

<sup>6</sup> References to codes and guidelines in this Statement of Disciplinary Action are references to the codes and guidelines that were current at the time of the listing of China Metal.

diligence and observe proper standards of market conduct, in the best interests of the integrity of the market.

- (b) Paragraph 5.8 (standard of documents) of the CFA Code of Conduct to use all reasonable efforts to assist its client in ensuring any document for public dissemination is prepared to the required standard and no relevant information has been omitted.
- (c) Paragraph 2.3 of the CFA Code of Conduct, paragraph IV.6 of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Management Guidelines**) and paragraph 1.5.2 of the Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers (**Sponsor Guidelines**), to maintain proper books and records and effective record retention policies which ensure that all relevant legal and regulatory requirements are complied with.
- (d) General Principle 7 (Compliance) and paragraph 12.1 (Compliance: in general) of the Code of Conduct and paragraph 1.5.1(3) of the Sponsor Guidelines to comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of the integrity of the market.

## Summary of facts

### *Background*

- 7. On 2 June 2008, China Metal submitted its first listing application with UBS acting as its sole sponsor, global coordinator, bookrunner and lead manager (**First Application**).
- 8. In November 2008, the SEHK noted that UBS was the holder of the Senior Notes<sup>7</sup> and the Listco Warrants<sup>8</sup> issued by China Metal. SEHK advised UBS that if 15% of the net proceeds from the Global Offering was applied to settle the debts due to UBS, UBS would become a non-independent sponsor<sup>9</sup>.
- 9. CMS became a joint sponsor of China Metal in or around November 2008.
- 10. On 24 February 2009, China Metal re-submitted a listing application (**Second Application**) whereby UBS and CMS were acting as its joint sponsors, but UBS retained the role as China Metal's sole global coordinator, bookrunner and lead manager.
- 11. On 22 June 2009, China Metal was listed on the Main Board of the SEHK.
- 12. According to its prospectus dated 10 June 2009, China Metal was a scrap metal recycling company in Mainland China with recycling facilities in Guangdong, Jiangsu and Hong Kong. An indirect wholly-owned subsidiary of China Metal, Central Steel (Macao Commercial Offshore) Limited (**Central Steel Macau**),

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<sup>7</sup> According to the prospectus, "Senior Notes" refer to the US\$80 million secured guaranteed senior notes due 2009 issued by China Metal on 23 October 2007. UBS Limited was the holder of US\$25 million or 31.25% of the Senior Notes (with coupon interest rate of 8.5% per annum).

<sup>8</sup> According to the prospectus, "Listco Warrants" refer to the warrants issued by China Metal to the holders of the Senior Notes. These Listco Warrants are exercisable only upon a primary public offering of the shares of China Metal on an internationally recognized stock exchange acceptable to the holders of the Senior Notes, which includes SEHK. UBS Limited was a holder of 50 Listco Warrants.

<sup>9</sup> See paragraph 3A.07(4) of the Rules Governing the Listing of Securities on the SEHK.

sourced scrap metal from international markets for China Metal's operations in China and it also sold scrap metal directly to external customers.

13. Trading in the shares of China Metal was suspended since 28 January 2013. On 26 February 2015, the Court of First Instance ordered that China Metal be wound up in the public interest upon the SFC's petition.

*Inadequate due diligence on a deregistered customer*

14. When UBS conducted due diligence on China Metal for the First Application, the top customers list and sales documents provided to UBS show that Company A was China Metal's largest customer in 2007, 2<sup>nd</sup> largest customer in 2006 and 7<sup>th</sup> largest customer in 2005.
15. However, another company, Company B and/or its affiliates, were described as China Metal's largest customer in 2007 and 2<sup>nd</sup> largest customer in 2006 in:
  - (a) the top customers list submitted by UBS to SEHK for the First Application;
  - (b) the top customers list submitted by UBS and CMS to the SEHK for the Second Application; and
  - (c) the prospectus.
16. The SFC's investigation found that, in the course of its due diligence, UBS discovered that Company A was deregistered on 26 March 2007 (**Deregistration**). However, sales documents provided by China Metal to UBS showed that Company A (as buyer) continued to enter into a number of sales contracts with Central Steel Macau (as seller) thereafter.
17. Upon enquiry, China Metal provided UBS with evolving explanations about its business relationship with Company A, including that the head office/main operation of Company A was actually another company which became China Metal's customer in 2008, and that Company A and Company B were part of a group of companies owned by the same beneficial owner which had conducted business with China Metal between 2005 and 2007.
18. Eventually, UBS accepted China Metal's explanation that Company B, whose beneficial owner was the same as Company A, had entered into contracts with Central Steel Macau in the name of Company A since the Deregistration. This was despite a number of red flags being raised whilst UBS conducted its due diligence:
  - (a) a report dated 21 March 2008 commissioned by UBS to look into this matter stated that, "*Since [Company A] has never engaged in any active business operation during its corporate history and has not reported any major transactions, we consider the claim that [Company A] is the largest customer of [China Metal] to be without merits (sic)*";
  - (b) the company registration documents of Company A and Company B that UBS obtained in March 2008 did not support the assertion that they were related;
  - (c) China Metal's Mainland Chinese lawyers informed UBS's foreign legal counsel (copying UBS) in early April 2008 that:
    - under Mainland Chinese law, a deregistered company is not entitled to enter into any business contracts, and as such contracts that Company

A entered into after its deregistration could be considered invalid and not enforceable; and

- even if Company A and Company B were related, Company A should not have conducted any business operation after its deregistration;
- (d) China Metal's Mainland Chinese lawyers further informed UBS in late April 2008 that they were not aware of any legal basis for describing Company B as one of the largest customers of China Metal; and
- (e) the documents provided by China Metal to UBS, including sales contracts, receipt vouchers and top customers list, showed that Company A was the entity which purchased scrap metal from China Metal or its subsidiary.
19. The SFC found that, by accepting China Metal's representation that Company B (instead of Company A) was its customer, UBS had failed to exercise professional scepticism in examining the information and documents provided by China Metal and other professional parties. UBS also did not conduct further enquiries to verify the relationship between China Metal, Company A and Company B to address the red flags raised during its due diligence.
20. With respect to CMS, although it only joined UBS as a joint sponsor of China Metal in or around November 2008, and was not involved in the due diligence conducted prior to November 2008 on this issue, it had an independent duty to conduct due diligence in order to have a thorough knowledge and understanding of China Metal and to satisfy itself in relation to the information disclosed in the prospectus.
21. The SFC considers that if CMS had reviewed the due diligence documents provided by UBS and other professional parties with professional skepticism, it would have discovered that there were two conflicting propositions on which entity or entities were contracting with China Metal at the material time (i.e. either Company A was the top customer of China Metal, or Company B was the top customer of China Metal but it entered into contracts with China Metal through Company A), both of which raised a number of red flags about the genuineness of the transactions between China Metal and Company A and/or Company B. The SFC considers that the evidence suggests that CMS did not conduct any follow up due diligence on this issue.

*Inadequate due diligence on third party payments*

22. In September 2008, when UBS was still a sole sponsor for China Metal, the reporting accountant of China Metal sent certain information to China Metal (copying UBS) regarding six of its customers who made payments to Central Steel Macau by cashier orders and/or remittance arranged by third party payers.
23. According to the information provided by the reporting accountant of China Metal, during the period from March to August 2008:
- (a) a payment of around US\$3.5 million payable by one of the six customers (Customer 1) to Central Steel Macau was settled by a third party payer through remittance via a bank based in New York;
  - (b) payments of around US\$1.1 million, US\$830,000 and US\$700,000 payable by three other customers (Customers 2, 3 and 4) to Central Steel Macau respectively were all settled by Customer 1 through remittance via a bank based in New York;

- (c) eight payments (of around US\$15.1 million) payable by another customer (Customer 5) to Central Steel Macau were settled by a third party through remittance via a bank based in New York;
- (d) eight payments of around US\$24.8 million payable by Customer 5 to Central Steel Macau were settled by cashier orders issued by a bank in Hong Kong; and
- (e) a payment of around US\$1.4 million payable by Customer 6 to Central Steel Macau was settled by a third party through remittance via a bank based in New York.

In total, around US\$47.5 million were paid to Central Steel Macau through third party payers.

#### *Customers 1 to 4*

- 24. The information provided by China Metal's reporting accountant described above shows that Customer 1 made payments to Central Steel Macau through a third party on the one hand, and made payments to Central Steel Macau on behalf of three other customers on the other hand. There is no evidence that UBS had followed up with China Metal or Customer 1 so as to understand the rationale of such payment arrangement.
- 25. Customer 1 was actually also Company B involved in the Deregistration issue. UBS was aware of the series of red flags raised in connection with the Deregistration issue (see paragraphs 14 to 19 above) before it received the relevant payment documents from China Metal and its reporting accountant. Company B's involvement in the unusual payment arrangements should have put UBS on alert to make enquiries to understand the rationale behind such arrangements, and the relationships between the parties involved. UBS informed the SFC that it is unclear whether its deal team was aware that Company B was the company which paid Central Steel Macau on behalf of three other customers.

#### *Customer 5*

- 26. UBS had followed up with China Metal in respect of the payments made by Customer 5. China Metal informed UBS that Customer 5, a customer in Mainland China, arranged for payment to be made to a third party paying company in Hong Kong, which in turn instructed its banker to remit US dollars to the account of Central Steel Macau.
- 27. UBS relied on its Mainland Chinese lawyers to provide legal advice on this payment arrangement. UBS was advised that, if the transactions between China Metal and Customer 5 were genuine, and that they had completed the relevant customs procedures, the legal liability of the third party payment arrangement adopted by Customer 5 should not affect China Metal. Therefore, the Mainland Chinese lawyers advised UBS to obtain various documents concerning the transactions in question. The documents requested by the Mainland Chinese lawyers included the payment records from the customer to its third party payer, and customs documents showing the import/export of concerned goods.
- 28. UBS did not obtain the requested documents and, instead, instructed the lawyers to provide their legal opinion on the assumption that the transactions in question were genuine.

29. While the focus of the Mainland Chinese lawyers' legal opinion was the legal implications of the payment arrangement on Central Steel Macau, UBS, in light of its specific obligations as a sponsor, should have taken steps to understand why Customer 5 relied on a third party to pay Central Steel Macau and whether there was a genuine business relationship between Customer 5 and China Metal but it has not done so.

Customer 6

30. There is no evidence that UBS had taken any steps to look into the relationship between Customer 6 and its third party payer to verify the authenticity of the payment arrangement and understand the rationale for the arrangement.

*Inadequate due diligence on China Metal's suppliers and customers*

31. UBS interviewed all suppliers of China Metal by telephone, and CMS also interviewed two suppliers by telephone before the filing of the Second Application, but there is no evidence that they had verified the telephone numbers and/or the identities of the supplier representatives they interviewed.
32. UBS and CMS conducted some of the interviews with China Metal's customers face-to-face and others over the telephone. The SFC's investigation revealed that:
- (a) none of the interview records indicates where the face-to-face interviews took place and whether UBS and/or CMS had taken any steps to verify whether the premises in which the interviews took place were the relevant customers' premises;
  - (b) there is also no evidence that UBS and/or CMS had taken any steps to verify the identity of any of the customer representatives they interviewed, so as to satisfy themselves that they had the appropriate authority for the interviews; and
  - (c) most of the customer interview records prepared by UBS are substantially incomplete in that no answers were recorded for the majority of the questions asked in most cases. For example, we note from the interview records for seven face-to-face customer interviews conducted by UBS:

<b>Customer No.</b>	<b>No. of questions</b>	<b>Questions Answered</b>	<b>Completion rate</b>
1	32	11	34%
2	32	13	41%
3	32	14	44%
4	32	10	31%
5	32	7	22%
6	32	3	9%
7	31	28	90%

33. UBS's substantially incomplete interview records cause us to question whether this is merely a record keeping failure, or whether it reveals a lack of due care, skill and diligence substantive failure on the part of UBS, i.e. UBS failed to obtain or follow up with the relevant customers for the missing answers. In any event, in the absence of proper records showing the information provided by the customers during the due diligence interviews, UBS was unable to demonstrate to the SFC whether it had verified and/or compared the information provided by

the customers (as recorded in the interview notes) against the information provided by China Metal and the customers' own corporate documents.

### **Breaches and reasons for action**

34. In light of the matters set out above, the SFC considers that UBS and CMS have respectively failed to discharge their duties as joint sponsors in relation to the listing application of China Metal, in that they have:
- (a) failed to conduct adequate and reasonable due diligence inquiries to ensure that the information and representations provided in the prospectus were true, accurate and not misleading, in that they have failed to:
    - (i) perform reasonable due diligence in relation to the Deregistration issue involving Company A, the alleged largest and second largest customers of China Metal in 2007 and 2006 respectively; and
    - (ii) take reasonable steps to verify the existence/identity of China Metal's suppliers/customers;
  - (b) breached the sponsor's undertaking to the SEHK and/or filed untrue statements in the sponsor's declaration to the SEHK; and
  - (c) failed to comply with all regulatory requirements applicable to the conduct of a sponsor, including the **Rules Governing the Listing of Securities on the SEHK (Listing Rules)** and Practice Note 21 to the Listing Rules (Due Diligence by Sponsors in respect of Initial Listing Applications).
35. Further, UBS has failed to: (i) follow up on a red flag raised by China Metal's reporting accountant in relation to the third party payments made to Central Steel Macau; and (ii) keep a proper audit trail/written record of the work done in relation to the due diligence for the listing application of China Metal.

### **Conclusion**

36. Having considered all the circumstances, the SFC is of the view that UBS and CMS have respectively breached the regulatory requirements as set out in paragraph 6 above.
37. In deciding the appropriate sanction against CMS<sup>10</sup>, the SFC has taken into account all relevant considerations, including:
- (a) CMS failed to exercise the important function of making a critical assessment with a questioning mind and being alert to red flags that contradict or bring into question the reliability of the information provided by China Metal and its joint sponsor;
  - (b) CMS failed to discharge its independent duty to carry out proper due diligence enquiries and/or critically examine the documents and information provided by China Metal and its joint sponsor that contradicted or brought into question the reliability of the information provided by China Metal;

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<sup>10</sup> See the SFC's press release on UBS dated 14 March 2019 regarding the factors that the SFC has taken into account in deciding the appropriate sanction against UBS in relation to its sponsor failings in the listing application of China Metal and two other listing applications.

- (c) CMS had assisted the listing of a company that was, in fact, not suitable for listing;
- (d) CMS cooperated with the SFC in accepting the disciplinary actions and the SFC's regulatory concerns; and
- (e) CMS agreed to engage an independent reviewer to review its policies, procedures and practices in relation to the conduct of its sponsor business.