

Hong Kong: SFC Action against IPO Sponsor

1. Background

On April 22, 2012 the Securities and Futures Commission (SFC) one of Hong Kong's main securities regulators and the body in charge of licensing securities industry participants in Hong Kong, revoked the licence of Mega Capital (Asia) Company Limited and fined it HK\$42 million (US\$5.38 million). Not only was this the largest fine ever handed down by the SFC, but also the first time a sponsor's licence has been revoked.

The SFC's action followed an investigation into Mega Capitals' practices and procedures whilst acting as sole sponsor to Hontex International Holdings Company Limited's December 2009 IPO on the Hong Kong Stock Exchange (HKSE). Trading in Hontex shares was suspended three months after its listing as a result of materially overstated figures for turnover and profits before tax in its IPO prospectus. At the same time, the SFC obtained a court order freezing some HK\$997.4 million (US\$127.8 million) held by Hontex and legal action is continuing with a view to requiring Hontex to return the IPO proceeds to public shareholders who bought shares during the IPO.

The SFC's action against Mega Capital follows the coming into force of the SFC's Sponsor Guidelines on January 1, 2007 which put in place a more rigorous regime governing sponsor due diligence work, and a more recent 'themed inspection' conducted by the SFC on 17 sponsors, starting late 2009, focusing on sponsor's work undertaken in initial listing applications. These inspections resulted in an SFC report issued in March 2011 noting certain deficiencies in the work performed by sponsors and inadequacies in their internal systems and controls including:

- Unsatisfactory due diligence on the listing applicant's business;
- Questionable disclosure to HKSE during the listing process;
- Failure to maintain proper documentation of due diligence; and
- Inadequate internal systems and controls over sponsor work.

2. SFC Findings against Mega Capital

The SFC's main findings against Mega Capital echoed the deficiencies noted in the SFC's March 2011 report, and included:

(1) Inadequate and sub-standard due diligence work

The principal businesses of Hontex are fabric sales and garment manufacturing (on an OEM basis for apparel owners and for Hontex's franchisees). Mega Capital's due diligence work was inadequate, for example:

- questionnaires, completed with suppliers and customers, failed to collect material information (eg. transaction figures with the Hontex group companies) and missing information was never followed-up;
- a number of interviews with suppliers and customers were conducted over the phone in haste on the day that Hontex filed its listing application; and
- information as to franchisees (name, address and turnover for each) provided by Hontex, was not verified properly and transaction records between franchisees and Hontex were not obtained.

(2) Failure to act independently and impartially

Important aspects of Mega Capital's due diligence work on Hontex's suppliers, customers and franchisees were sourced from Hontex without independent scrutiny. For example:

- Mega Capital agreed to Hontex's request that it should not approach the group's suppliers, customers and franchisees directly, and as a result all interviews were arranged by Hontex and conducted in the presence of Hontex's representatives;
- Mega Capital accepted Hontex's representation, without any inquiries, that some of its suppliers/customers refused to have face-to-face interviews, and accepted the arrangement to have telephone interviews with these suppliers/customers, arranged by Hontex; and
- written confirmations from franchisees confirming that they were independent from Hontex were obtained through Hontex.

(3) Inadequate audit trail of due diligence work

Mega Capital failed to adequately document their due diligence planning and significant aspects of their due diligence work. For example, there are no records showing what background or other due diligence searches had been conducted by Mega Capital on the suppliers, customers and franchisees of the Hontex group.

(4) Inadequate supervision of its staff

- most of the due diligence work was handled by junior and inexperienced staff of Mega Capital without adequate supervision; and
- each of the two 'responsible officers' at Mega Capital denied that that they were responsible for the listing application.

Whilst the SFC found no evidence that Mega Capital was involved in any fraud, its failure in discharging its sponsor's duties "prejudiced the regulatory assessment of Hontex's suitability for listing and jeopardized the interests of the investing public". SFC investigations are continuing against the two 'responsible officers' (required by law to be appointed for each SFC-licensed entity) of Mega Capital.

3. Practical Suggestions for Sponsors

The main regulatory requirements for IPO sponsors are contained in Chapter 3A and Practice Note 21 (**PN21**) of the HKSE Listing Rules and various SFC Codes/Guidelines, including the SFC's Sponsor Guidelines and Corporate Finance Adviser Code of Conduct. The SFC's Sponsor Guidelines set out requirements as to fitness and properness to remain licensed and other ongoing requirements of a sponsor including maintaining effective systems and controls, appointment of transaction teams and management responsibility/supervision. The Listing Rule provisions require sponsors to conduct reasonable due diligence so as to put themselves in a position to make a declaration to HKSE concerning the new applicant and the contents of the listing document.

The following list contains practical suggestions for sponsors, although it is obviously not exhaustive:

Due Diligence

- plan due diligence to be appropriate for the particular listing applicant's business, including on:
 - the applicant's performance and finances, business plan and any profit forecast or estimate;
 - major business stakeholders (suppliers, customers, creditors and bankers);
 - any material change in business shortly before listing;
- document the due diligence planning, including any significant deviations from the plans, as well as any decisions taken to exclude disclosure of a particular matter on the basis of immateriality;
- allow sufficient time for due diligence to be conducted properly and keep a proper trail of the due diligence work undertaken;

- verify the identity of interviewees, allow interviews to take place free from interference by the listing applicant, and follow-up incomplete/unsatisfactory responses;
- avoid over-reliance on the listing applicant (eg. setting up interviews or sending out questionnaires etc.) and be particularly sceptical to any unnecessary involvement by or if any resistance originates, or appears to originate, from the listing applicant itself. Where possible verify information independently from the listing applicant;
- maintain effective record retention policies - to demonstrate compliance with all legal and regulatory requirements and enable the SFC to carry out ad hoc or comprehensive reviews or investigations to assess compliance; and
- do not rely blindly on expert's work/opinions - consider whether:
 - it is reasonable to rely on such information and advice;
 - the expert's opinion is based on confirmations/representations from the management of the listing applicant without further independent enquiries or assessment by a third party;
 - the assumptions disclosed by the expert are fair, reasonable and complete by reference to the sponsor's knowledge of the new applicant; and
 - any follow-up is required for inconsistent statements etc..

Internal Controls

For each transaction, a Principal should supervise the IPO transaction team, be involved in key decisions and be aware of the key risks and responsible for measures to address them. Sponsors must also ensure manpower and resources are commensurate with the volume, size and complexity of sponsor work undertaken and conduct an annual assessment of their systems and controls to ensure compliance with all laws/regulations applicable to sponsor work.

4. Expected regulatory changes

Although responsibility for the information in listing documents lies primarily with the directors of listing applicants, it is a regulatory requirement that sponsors should also be closely involved in the preparation of the new applicant's listing documents.

Since March 2011, the SFC has issued repeated warnings about the quality of sponsor due diligence work in relation to IPO applicants and there are well publicized plans for the imminent launch by the SFC of a public consultation which would potentially see criminal sanctions in place for investment bankers and hefty fines for sponsors where they fail to meet their responsibilities in sponsoring new listing applicants in Hong Kong.

In addition, listed issuers and their directors/chief executives are expected to face civil penalties and fines of up to HK\$8 million for failing to disclose price-sensitive

information as and when a proposal (currently before Legco, the law making body in Hong Kong) is brought into effect in the near future.

5. Conclusion

Whilst the SFC's action against Mega Capital has made headlines across the world, it simply confirms the SFC's determination to continue along a path - the direction of which has been clear for some time now - and is perhaps evidence that the SFC has now given sponsors enough time to prepare themselves for the regulatory environment ahead.

The SFC already has wide powers to fine sponsors and their licensed representatives, and may also suspend or revoke their licences effectively forcing them out of the industry. It is also widely acknowledged that listing standards in Hong Kong are strict, even by international standards, but given the HKSE's position as the world's largest IPO market for a third year running in 2011, its inherent weighting towards Chinese related businesses and the recent adverse publicity (not just in Hong Kong, but globally) involving Chinese issuers, it is perhaps no real surprise to see the SFC broadcasting the message to IPO sponsors in no uncertain terms.

If you have any questions, please feel free to contact Freeman Chan, or any of your regular contacts at the firm.

6. Related Links

- [SFC press release re. Mega Capital](#) (22 April 2012)
- [SFC Sponsor Guidelines](#) - see Appendix 1 (Jan 2007)
- [SFC Report on Sponsor Theme Inspection Findings](#) (March 2011)
- [SFC Code of Conduct for Persons Licensed by or registered with the SFC](#) (Oct 2011)
- [SFC Corporate Finance Adviser Code of Conduct](#) (Oct 2011)
- [Chapter 3A](#) & [Practice Note 21](#) of the HKSE Main Board Listing Rules

CLEARY GOTTLIB STEEN & HAMILTON LLP

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING

Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299