UPDATE ON THE SFC'S FRONT-LOADED REGULATORY APPROACH

7 February 2020

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On 7 February 2020, SFC published a special edition of its **SFC Regulatory Bulletin** to provide an update on its front-loaded approach to address market quality and corporate conduct issues. It provides some case studies illustrate the SFC's key areas of concern and recent regulatory interventions in IPO applications and corporate transactions by listed companies. Below are the main points set out by the bulletin:

A. GENERAL

1. SFC has the power to raise objections to a listing application or direct SEHK to suspend trading in a listed company's shares.

2. SFC has the power to query or object to suspicious corporate transactions, for instance, if they do not appear to make commercial sense.

3. SFC has the power to freeze unlawful proceeds, seek disqualification orders against irresponsible directors, discipline sponsors and suspend the share trading of listed companies.

B. SPONSORS

1. **Due diligence in general:** 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 shall thoroughly understand a listing applicant's business model, industry environment and associated risks.

   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.

2. **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. Sponsors are advised to avoid a "box ticking" approach. They should design a customized due diligence plan for each listing applicant and adhere to it.

3. **Due diligence on financial information:** A listing applicant recorded a significant increase in average customer spending per transaction during the track record period. Revenue fluctuations did not align with the seasonality of the business.

   A 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.

   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 SFC.

   A 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.

4. **Due diligence on assets:** Sponsors should verify key business assets (including their physical existence and legal entitlements) and seek the assistance of qualified and reliable experts when required.

A sponsor relied on Mainland lawyers to verify certificates of legal title to the listing applicant's assets on the Mainland. The law firm only performed a desktop review of the certificates without independently verifying their authenticity or the actual existence of the assets.

5. **Due diligence on customers:** 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.

   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.

6. **Proper record:** Detailed records of due diligence should be kept to demonstrate compliance with regulatory requirements.

7. **Third parties' work:** Over-reliance on third-party professionals such as lawyers and accountants. Sponsors remain ultimately responsible. Sponsor must supervise the agents and ensure that they sufficiently understand the depth and scope of the task.

8. **Oversight 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.

   Sponsors need to ensure that each transaction team is properly and adequately supervised by at least one qualified sponsor principal.

9. **History of returned or rejected listing applications:** 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.

C. CORPORATE TRANSACTIONS

1. **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.

2. **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.

SFC reminds 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.

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. After SFC issued letters to the company, the company terminated the acquisition.

A 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. After SFC issued a letter to the company, the company terminated the acquisition.

3. **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. SFC 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 SFC issued a letter to the company, the company terminated the acquisition.

   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. SFC raised concerns whether there were any undisclosed relationships or arrangements among the company, the target, their respective controlling shareholders and Mr A. After SFC 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, SFC did not pursue the matter further.

4. **Warehousing of shares and nominee arrangements:** SFC look carefully at 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.

5. **Highly dilutive rights issues:** SFC has seen highly dilutive rights issues and open offers structured or conducted in a manner which appeared to be against the interests of minority shareholders. With the measures by SEHK and SFC, there was a substantial drop in the number of these transactions. There were also fewer deeply discounted share placements, an area where SFC often directly intervened.

6. **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. SFC issued an initial letter of concern followed by a letter of mindedness. The company subsequently announced the termination of the transaction.

In another case, SFC 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. SFC 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.

D. DIRECTORS' DUTIES

1. **General:** 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.

2. **Independent non-executive directors:** 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 the markets.

   When independent non-executive directors 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.

3. **Enforcement:** 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, SFC worked jointly with the Independent Commission Against Corruption (ICAC) to crack down on a highly suspicious and sophisticated scheme, allegedly designed to defraud shareholders.

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