



Hong Kong

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HONG KONG SFC IMPOSES HK\$27 MLN FINE FOR SPONSOR DUE DILIGENCE FAILURES

Introduction

The Securities and Futures Commission (**SFC**) has reprimanded and imposed fines totalling HK\$27 million on China Merchants Securities (HK) Co., Limited (**China Merchants**) for IPO sponsor due diligence failures relating to its joint sponsorship of the listing application of China Metal Recycling (Holdings) Limited (**China Metal**) which listed on the Hong Kong Stock Exchange in 2009. The disciplinary action follows the SFC's earlier sanctions imposed on the other joint sponsors, UBS AG and UBS Securities Hong Kong Limited (together, **UBS**), for their sponsor due diligence failures. The crackdown on sponsor failures is ongoing; in April 2019, the SFC imposed record fines on four investment banks for breaches of their obligations as IPO sponsors of the listing applications for China Forestry Holdings Company Limited and Tianhe Chemicals Group Limited. For further information regarding those disciplinary actions, please refer to our April 2019 newsletter.¹

In the latest case, China Merchants and UBS were found to have breached sponsors' obligations to conduct adequate and reasonable due diligence in:

1. failing to perform reasonable due diligence on a deregistered customer, alleged to have been China Metal's largest and second largest customer for 2007 and 2006, respectively;

2. failing to take reasonable steps to verify the existence/identity of China Metal's suppliers and customers;
3. breaching the sponsor's undertaking to the Hong Kong Stock Exchange and/or filed untrue statements in its sponsor's declaration;
4. failing to comply with the regulatory requirements for sponsors under the HKEx Listing Rules and Practice Note 21 to the Listing Rules (Due Diligence by Sponsors in respect of Initial Listing Applications).

UBS was additionally found to have failed to follow up on a red flag raised by the listing applicant's reporting accountant in relation to third party payments made to its subsidiary and to keep a proper audit trail/ written record of the due diligence conducted for the listing application.

Although China Merchants was appointed as a joint sponsor of China Metal's listing application in November 2008 and was not involved in the due diligence previously conducted by UBS, each sponsor has an independent duty to conduct due diligence on the listing applicant. The SFC found that China Merchants failed to fulfil that independent duty and in particular, had failed to review the due diligence documents provided by UBS with professional scepticism.

The SFC's announcement² of the outcome of the disciplinary

¹ <https://www.charltonslaw.com/sfc-imposes-record-fines-for-sponsor-failures/>

² <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=19PR44>

proceedings and the SFC's Statement of Disciplinary Action³ are available on the SFC website.

The pre-October 2013 Sponsor Due Diligence Regime

The due diligence in relation to China Metal was however conducted under the pre-2013 regulatory regime for Hong Kong sponsors, that is before the introduction of the more onerous and specific due diligence obligations under what is now Paragraph 17 of the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the **SFC Code of Conduct**).

The regulatory requirements for IPO sponsors at the time of the China Metal listing applications consisted of:

1. Practice Note 21 to the Hong Kong Listing Rules – Due Diligence by Sponsors in respect of Initial Listing Applications which sets out the Hong Kong Stock Exchange's expectations for sponsor due diligence, including that sponsors should document their due diligence planning, any significant deviations from their plans and their conclusions on whether the listing applicant meets the HKEx Listing Rules' criteria for listing. It also sets out a number of 'typical due diligence inquiries', which in relation to supplier and customer interviews, provide only that an assessment of a listing applicant's "performance and finances, business plan ... past performance, including historical sales, revenue and investment returns, payment terms with suppliers would *often* involve interviewing the new applicant's major suppliers and customers, creditors and bankers".⁴
2. General Principle 2 of the SFC Code of Conduct (on diligence) and the obligation under Paragraph 5.1 of the Corporate Finance Adviser Code of Conduct to act with due skill, care and diligence and act in the best interests of the market's integrity.
3. Paragraph 5.8 of the Corporate Finance Adviser Code of Conduct to use all reasonable efforts to assist a client to ensure that any document prepared for public dissemination is prepared to the required standard and does not omit any material information.

4. Obligations to maintain proper books and records under Paragraph 2.3 of the Corporate Finance Adviser Code of Conduct and other SFC regulatory guidelines.

At the time, sponsors were under no explicit obligation to conduct customer and supplier interviews, let alone to conduct them in any particular manner. That changed in October 2013 with the implementation of Paragraph 17 of the SFC Code of Conduct. Paragraph 17.6(f) contains detailed requirements for sponsors' conduct of interviews of major business stakeholders, including a listing applicant's customers and suppliers, including (among others) that the sponsor should:

1. confirm the bona fides of the interviewee, including establishing the interviewee's identity and other relevant information, to ascertain that the interviewee has the appropriate authority and knowledge for the interview;
2. carry out the interview directly with the person or entity selected for interview with minimal involvement of the listing applicant;
3. hold an in-depth discussion to obtain adequate answers to all questions raised and follow up on any incomplete or unsatisfactory responses or outstanding matters; and
4. identify any irregularities noted during the interview – examples of which are stated to be the interview not taking place at the registered or business address of the interviewee (e.g. at the office of the listing applicant) and reluctance on the interviewee's part to cooperate.

It is however clear from the SFC's December 2012 Consultation Conclusions⁵ on the 2013 sponsor regulatory regime that it applied only to sponsors submitting a listing application on or after 1 October 2013.⁶ In the China Merchants case, and also in the recent SFC disciplinary actions against Standard Chartered Securities (Hong Kong) Limited, Morgan Stanley Asia Limited, and Merrill Lynch Far East Limited, it would seem that, at least in relation to the conduct of interviews, the sponsors were judged by reference to the requirements of Paragraph 17.6(f) of the SFC Code of Conduct, notwithstanding that it was not in effect at the time of the relevant listing applications. Criticisms that UBS and China Merchants, for example, had not verified: (a) that interviews took place at customers' business premises;

³ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/openAppendix?refNo=19PR44&appendix=0>

⁴ Paragraph 13(b) of Practice Note 21 the HKEx Listing Rules.

⁵ <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=12CP1>

⁶ SFC. "Consultation Conclusions on the regulation of IPO sponsors". 12 December 2012. Paragraph 45.

or (b) the identity of interviewees in order to establish their authority to participate in the interview, appear to refer directly to the requirements of Paragraph 17.6(f).

The Facts

UBS submitted China Metal's first listing application to the Hong Kong Stock Exchange on 2 June 2008. A second listing application was submitted on 24 February 2009 after China Merchants' appointment as a joint sponsor in November 2008.

China Metal was a scrap metal recycling company in Mainland China with recycling facilities in Guangdong, Jiangsu and Hong Kong. It listed on the Main Board of the Hong Kong Stock Exchange on 22 June 2009, but its shares were suspended from trading in January 2013, and the Court of First Instance ordered that it be wound up on application by the SFC in February 2015.

First Breach: Inadequate due diligence on a deregistered customer

During the course of due diligence on China Metal for the first listing application, UBS discovered that Company A, China Metal's largest customer in 2007, second largest customer in 2006 and seventh largest customer in 2005, had been deregistered in March 2007. However, the list of top customers submitted to the Hong Kong Stock Exchange with both the first and second listing application, and included in the listing prospectus, named another company, Company B, as China Metal's largest and second largest customer for 2007 and 2006. The SFC demonstrated that UBS was aware from its due diligence that Company A was deregistered in March 2007 and of sales documents provided by China Metal showing that Company A continued to enter into sales contracts with Central Steel Macau, a wholly-owned subsidiary of China Metal after that date.

UBS apparently accepted China Metal's explanation that Company B, which had the same beneficial owner as Company A, had entered into contracts with Central Steel Macau in the name of Company A since the deregistration, despite the following red flags:

1. a report in early 2008 commissioned by UBS cast doubt on Company A's status as China Metal's largest customer noting that Company A had never engaged in any active business operation and had not reported any major transactions;

2. the company registration documents obtained by UBS in March 2008 did not support the purported relationship between the two companies;
3. China Metal's Mainland Chinese lawyers informed UBS's foreign legal counsel in early April 2008 that even if Company A and Company B were related, a deregistered company is not entitled to enter into any business contracts, and should not have conducted any business operation after its deregistration;
4. China Metal's Mainland Chinese lawyers further notified UBS in late April 2008 that they could not find any legal basis supporting the assertion that Company B was one of China Metal's largest customers; and
5. transaction documents provided by China Metal to UBS indicated that Company A was the entity which purchased scrap metal from China Metal or its subsidiary.

UBS was found to have failed to exercise professional scepticism in accepting China Metal's assertion that its customer was Company B, rather than Company A. It should instead have conducted follow-up enquiries to address the red flags raised during due diligence. The SFC found that China Merchants had failed to perform its independent duty to conduct due diligence in order to obtain a thorough knowledge and understanding of China Metal and verify the information disclosed in the prospectus. The SFC found no evidence that China Merchants had conducted any further due diligence into the genuineness of the transactions between China Metal and Company A and/or Company B despite the red flags.

Second Breach: Inadequate due diligence on third party payments

When UBS was still a sole sponsor for China Metal, the company's reporting accountant sent information to China Metal, which it copied to UBS, regarding six customers who made payments to Central Steel Macau by cashier orders and/or remittance arranged by third party payers. A total of around US\$47.5 million was paid to Central Steel Macau through third party payers. In particular:

1. One of the customers made payments to Central Steel Macau through a third party on the one hand, while making payments on behalf of three other customers on the other hand. It was later found that this customer was in fact Company B, which UBS already knew to have been deregistered. There is no evidence indicating

that UBS followed up with China Metal or the customer to ascertain the rationale for the payment arrangement. Given that UBS was already aware of the deregistration issue in relation to Company B, the SFC considered that UBS should have been put on alert to make further enquiries into the payment arrangements.

2. In relation to a Mainland Chinese customer who arranged for payments to be made via a third party paying company in Hong Kong, UBS failed to follow advice from its Mainland Chinese lawyers that it should obtain transaction documents to ascertain whether the transactions between the customer and China Metal were genuine. Instead, UBS asked the lawyers to provide the legal opinion on the assumption that the transactions were genuine. The SFC found that UBS should have taken steps to understand the reason for using a third party to make payments and to ascertain whether a genuine business relationship existed between the customer and China Metal.
3. In relation to a further customer, UBS failed to take any steps to understand its relationship with a third party payer or to verify the payment arrangement's authenticity.

Third Breach: Inadequate due diligence on China Metal's suppliers and customers

Before submitting the second listing application, UBS interviewed all China Metal's suppliers by telephone and China Merchants interviewed two suppliers by telephone. There was no evidence, however, that either sponsor verified the telephone numbers and/or the identities of the supplier representatives interviewed.

The SFC investigation into the customer interviews, some of which were conducted face-to-face and others by telephone, found a number of irregularities, including that:

1. the interview records failed to record where the face-to-face interviews took place and whether UBS and/or China Merchants had taken any steps to verify whether the premises in which the interviews took place were the relevant customers' premises;
2. there was no evidence that UBS and/or China Merchants had taken steps to verify the identity of the interviewed customer representatives to satisfy themselves that the representatives had the appropriate authority to conduct the interviews; and

3. most of the interview records prepared by UBS were substantially incomplete with no answers recorded for the majority of the questions asked in many cases. UBS had further failed to follow up with customers in relation to the missing answers.

The SFC found that UBS was unable to demonstrate to the SFC that it had verified and/or compared the information provided by the customers against the information provided by China Metal and the customers' own corporate documents.

Conclusion

The SFC formed the view that both UBS and China Merchants had failed to conduct adequate and reasonable due diligence inquiries and breached the relevant regulatory requirements.

In determining the penalty to be imposed on China Merchants, the SFC took into consideration China Merchants' failure to:

1. exercise the important function critically assessing with a questioning mind and being alert to red flags that cast doubt on the reliability of the information provided by China Metal and its joint sponsor; and
2. discharge its independent duty to carry out proper due diligence enquires 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.

The SFC also took note of China Merchants' cooperation with the SFC in accepting the disciplinary actions and the SFC's regulatory concerns, and its agreement to engage an independent reviewer to review its policies, procedures and practices for the conduct of its sponsor business.

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