

SFC identifies continued deficiencies in sponsor work

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On 26 March 2018, the Securities and Futures Commission (the "**SFC**") issued a [Circular to licensed corporations on expected standards for sponsor work](#) (the "**Circular**") and a [Report on the Thematic Review of Licensed Corporations Engaged in Sponsor Business](#) (the "**Report**") following a thematic inspection of sponsors, which found a number of compliance failures and deficiencies in standards of conduct, due diligence practices, and internal systems and controls. These included:

- Failure of sponsors to follow up on due diligence despite obvious red flags, such as:
 - i. large discrepancies between sales data provided by the company and financial information retrieved from local government offices; and
 - ii. relying on a statutory declaration and confirmation as sufficient to ensure accuracy of prospectus disclosure when inconsistencies, backdating and other errors obtained cast doubt on validity of certain arrangements.
- Merely following standard due diligence checklists without adapting them to the circumstances of specific listing applications, which was particularly ineffective when key aspects of listing applicants' businesses fall outside the scope of standard checklists.

The SFC has urged licensed corporations that carry out sponsor work to critically review and enhance their systems and controls, and has emphasised that it will not hesitate to take enforcement actions against sponsors and their senior executives responsible for failure to comply with the expected standards.

Based on publicly available information, the SFC or the Stock Exchange of Hong Kong Limited has returned or rejected 44 listing applications between October 2013 and March 2018. The sponsors' work or the listing application materials in a number of these cases failed to meet the expected standards. In certain cases, the SFC identified concerns that should have been discovered and addressed by reasonable due diligence prior to submission of the listing application. In other cases, these concerns delayed the listing timetable considerably, or led to the lapse of the listing application.

Sponsors who have had a history of returned or rejected listing applications or serious deficiencies and instances of non-compliance may also expect more frequent inspection visits, supervisory actions, and closer regulatory scrutiny when submitting future listing applications.

Detailed findings and expected standards are set out in the Report and the Circular. The table below summarises the expected standards of good practice in certain key areas of sponsor work:

KEY AREA	OVERARCHING PRINCIPLE	EXAMPLES IN PRACTICE
DUE DILIGENCE	<p>Use reasonable judgement and apply professional scepticism</p> <p>Attain a sound understanding of the listing applicant based on reasonable due diligence</p>	<ul style="list-style-type: none"> – Obtain sales walkthrough documents to verify business operations as described in the prospectus – Follow up on any key issues or discrepancies that arise in these documents – Conduct reasonable due diligence on the listing applicant's major retail or online customers, especially those that account for a materially larger portion of sales than other stores or customers, or where significant variance is observed from industry peers – Consider implications of any special arrangements with unrelated third parties or customers outside the ordinary course of business – Perform background research on the listing applicant and update regularly where the listing process continues for some time or if the listing applicant operates in a fast-evolving industry or regulatory environment
	<p>Customised due diligence plans</p> <p>Develop customised due diligence plans and keep comprehensive records</p>	<ul style="list-style-type: none"> – Robust, comprehensive and customised due diligence plans should be developed at the start of each engagement, instead of relying on a generic checklist – Give due and careful consideration to all major areas of the due diligence process at an early stage to avoid pressure to resolve issues quickly down the road at the risk of affecting the timetable – Due diligence plans should not merely confirm that broad due diligence measures have been taken, but should also demonstrate (i) factors considered in planning the due diligence, (ii) the specific due diligence conducted, and (iii) any issues identified and steps taken to resolve them – Adapt due diligence plans and checklists as needed during the listing process. Plans, checklists and subsequent updates should be approved by designated senior members of the transaction team and properly recorded – Proper records should be kept documenting breadth and depth of due diligence and results (see <i>Proper Records</i> section below)

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	<p>Relying on third parties</p> <p>Sponsors remain responsible for matters related to tasks undertaken by a third party</p>	<ul style="list-style-type: none"> – Do not simply use a third party's work as evidence that they have discharged their due diligence obligations. In itself, the third party's work, such as a legal opinion, an internal control review report or an investigation report) is not sufficient evidence of a sponsor's due diligence – Sponsors should be able to demonstrate that they have given due consideration as to whether such work could form the basis for them to discharge the due diligence obligation – Sponsors should be able to explain: <ul style="list-style-type: none"> • Why they decided to rely on a particular third party (including due consideration given to the third party's qualifications and competence) • Whether they communicated to the third party the scope and extent of due diligence to be conducted • Whether the work of the third party provided a sufficient basis to determine that reasonable due diligence had been conducted, and whether further due diligence was required, considering the extent of work conducted, the standards under which it was conducted, and the fairness, reasonableness, and completeness of the bases and assumptions for the reports or opinions
	<p>Relying on experts</p> <p>Critically review the expert's opinion and conduct follow-up work to resolve any material discrepancies, irregularities or inconsistencies</p>	<ul style="list-style-type: none"> – Conduct further enquiries if there are any concern about the information underlying the accountant's report or any other expert report – While auditors are responsible for auditing the listing applicant's accounts, this does not relieve sponsors from their responsibility to assess the listing applicant's financial and business performance – Be able to demonstrate that the following has been considered: (i) how an expert's report could form the basis for discharging due diligence obligations, and (ii) whether any additional due diligence is required

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	<p>Identify and follow up on red flags</p> <p>Take reasonable steps to identify red flags, cross-check information from different sources, and follow up on, and resolve, any material irregularities</p>	<ul style="list-style-type: none"> – Compare sales information provided by the listing applicant with sales information obtained from interviews with major customers and/or total turnover of major industry players obtained from official statistics or consultancy firms – Exercise professional scepticism of claims that an abnormal practice or unusual business conduct is the industry norm or common practice. Focus on whether such practice or business conduct cast doubt on the genuineness of the financials of the listing applicant, its legality and commercial rationale – Attain an understanding of the potential liability and other implications of such practice or conduct
INTERVIEW PRACTICES	<p>Interviewees to have appropriate authority and knowledge</p> <p>Exercise due care in confirming the bona fides of interviewees so as to be satisfied that they have the appropriate authority and knowledge</p>	<ul style="list-style-type: none"> – Conduct interviews at the interviewees' business premises as far as possible, and conduct further cross-reference checks of more than one type of proof of identity. Otherwise, ensure any irregularities are adequately explained and resolved – Take reasonable alternative steps to verify the interviewee's bona fides – For telephone interviews, verify the telephone numbers and identities of the interviewees. Do not rely solely on telephone numbers provided by the listing applicant to verify an interviewee's identity. Instead, possible steps include calling the general line of the interviewee's company obtained from a reliable public source to verify the interviewee's position and that the individual participated in the interview – To ensure that the interviewee's representations reflected the position of their respective company, sponsors may request telephone interview notes to be validated by the interviewee's company with copies of the interviewee's identity documents attached

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	Document interviews in sufficient detail	<ul style="list-style-type: none"> – Record criteria for selecting interviewees – If any persons selected refused to attend the interview, document the reasons and how this was followed up on – Record name and position of any other person present during the interview (especially if representatives from the listing applicant insist on attending the interview)
PROPER RECORDS	<p>Prepare a detailed due diligence plan and document the work conducted</p> <p>Maintain sufficient records to demonstrate proper due diligence and adequate investigation into contentious issues and conclusions</p>	<ul style="list-style-type: none"> – Specific issues identified (including all material risks) during due diligence and steps taken to resolve them should be properly recorded. Stand-alone due diligence notes can be used as appropriate – For example, criteria for selecting sites to visits for the listing applicant's main business locations, customers, or suppliers should be recorded, as well as the names of the sites inspected, participants in the site visits, any verification work conducted, and all instructions or guidance provided to participating staff – Records should be sufficiently exact and detailed, and if requested by the SFC, to enable provision of a "proper trail of work done". A "bare bones" outline setting out only broad and entirely expected areas of due diligence is insufficient – Comprehensive record should be maintained of matters material to the listing applicant's business, including: <ul style="list-style-type: none"> • the listing applicant's major customers, suppliers, bankers and creditors; • the listing applicant's directors and senior management; • material assets used or to be used in connection with the business; • contracts material to the business; • legal proceedings and other material disputes the listing applicant or its subsidiaries are involved or may be involved in; and • the existence, validity and business aspects of proprietary interests, intellectual property rights, licensing arrangements and other intangible rights

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	Ensure records can be located and retrieved	<ul style="list-style-type: none"> – As the sponsor work may experience a high turnover of personnel, sponsors should ensure that they can locate and retrieve records after transaction team members depart
RESOURCES, SYSTEMS AND CONTROLS	<p>Corporate governance</p> <p>Management of a sponsor is ultimately accountable for the firm's compliance with the applicable codes, rules and regulations</p>	<ul style="list-style-type: none"> – Management of a sponsor should maintain satisfactory operational controls and risk management procedures, and adequate human and technical resources – The board of directors (the "Board") and other members of Management (including relevant committees designated by the Board) should be structured in a way which enables the board to oversee and control activities of the firm effectively – Organisational structure should be documented, setting out the managers in charge and responsible for overall management oversight of the firm and those specifically responsible for directing and overseeing the sponsor business, as well as their reporting lines. This structure should be approved by the Board – Maintain clear policies requiring critical matters to be escalated to the Board, responsible managers in charge or designated committees for consideration – Management of sponsors should ensure the appropriateness of the team structure for each sponsor engagement. Sponsor principals should maintain an effective reporting line and communication among transaction teams and other members of Management regarding sponsor work undertaken – Be able to demonstrate involvement of Management in consideration of key issues

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	Other aspects	<ul style="list-style-type: none"> – Ensure that sufficient resources are allocated to each engagement and provide sufficient training, guidance and management supervision over sponsor work – Escalation policies should, among other things, cite examples of material risks and issues, and specify an appropriate threshold for internal escalation. This is particularly helpful for junior staff members who are usually responsible for the main due diligence under supervision of more senior staff and the sponsor Principal – Provide scenario-based training for identifying and resolving material issues, and supplement with on-the-job training by the sponsor Principal or other senior staff – Maintain records of escalation of critical matters to Management and their final resolution – Sponsor Principals should adequately supervise their transaction teams at all times. They should attend key due diligence interviews together with junior team members to be better informed about the listing applicants and provide timely guidance when needed
	Annual assessment of system and controls	<ul style="list-style-type: none"> – Annual assessments are not to rely solely on attestation of the sponsor Principals – Conduct critical review of policies and procedures to ensure compliance with relevant codes, rules and regulations – Conduct reviews of listing application samples to ensure that key policies and procedures are effectively implemented

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