

Corporate & Commercial

Sponsor Penalised for Serious Deficiencies in Due Diligence Work

In a recent case of *Sun Hung Kai International Limited v Securities and Futures Commission* SFAT Application No. 3/2013, the Securities and Futures Appeals Tribunal (the “**SFAT**”) has affirmed the Securities and Futures Commission’s (the “**SFC**”) decision to sanction Sun Hung Kai International Limited (the “**Company**”), reprimanded it and fined it HK\$12 million and suspended its licence to provide advisory service on corporate finance for one year after finding serious deficiencies in the sponsor work relating to the listing of Sino-Life Group Limited (“**Sino-Life**”) on the Growth Enterprise Market Board (“**GEM Board**”) of the Hong Kong Stock Exchange of Hong Kong Limited (“**HKEx**”).

Background

The Company was appointed by Sino-Life in October 2007 to manage its application for a listing on the GEM Board. Sino-Life was successfully listed on the GEM Board on 9 September 2009. Immediately after Sino-Life’s listing, SFC commenced its investigation into the manner in which the Company had discharged its duties as sponsor. After around three and a half years’ of investigation, SFC alleged that the Company (i) failed to conduct proper due diligence between October 2007 and September 2009 on Sino-Life’s business in relation to a number of material issues; (ii) placed undue reliance on the work of external experts and (iii) failed to keep proper record. The Company appealed to the SFAT and the SFAT affirmed SFC’s decision. The SFC’s and SFAT’s main findings are outlined below.

The SFAT’s findings

1. Failure to exercise due diligence in questioning the change of auditors in the course of listing and the difference in cash flow figures contained in the draft audit report prepared by the former auditor and the later auditor

The draft audit report dated March 2008 prepared by the former auditor (“**Former Audit Report**”) showed that Sino-Life’s cash flow figure for the financial year ended 2006 and 2007 was approximately RMB3.767 million and RMB7.007 million respectively, an aggregate of some HKD10.8 million for the two years immediately preceding the issue of listing document. In May 2008, HKEx announced a more stringent financial requirement for listing in GEM Board, requiring new applicant to have cash flow of at least HKD20 million for the two financial years immediately preceding the issue of listing document (the “**New Listing Requirement**”). Since the Former Audit Report revealed a cash flow materially below the New Listing Requirement, Sino-Life applied for a waiver

of the New Listing Requirement. Yet, its application was rejected and its listing application was then halted.

After several months, Sino-Life revived its listing application, retaining the Company as sponsor but appointed a new auditor. The new auditor prepared another audit report dated February 2009 (“**Final Audit Report**”) which showed that Sino-Life’s cash flow figure for the year ended 2007 and 2008 was RMB10.230 million and RMB10.324 million respectively, an aggregate of some RMB20.5 million, just meeting the New Listing Requirement.

SFAT found that the Company was well aware of the huge difference in cash flow figure for the financial year ended 2007 between the Former Audit Report and the Final Audit Report (RMB7.007 million vs RMB10.230 million) (the “**Difference**”). The Difference constituted a material issue but the Company failed to carry out critical assessment and making further enquiry. The Company has failed as a sponsor to confirm all the basic qualification of the listing had been met and make necessary disclosure to HKEx in handling the listing application.

Rule 6A.04 of the Stock Exchange Listing Rules provided that “*Each sponsor must undertake to use reasonable endeavours to ensure that all information provided to the Exchange during the listing application process is true in all material respects and does not omit any material information*”. SFAT found that the Company’s failure to reveal the Difference to HKEx in the listing application and subsequent enquiries from the HKEx constituted omit to material information.

2. Failure to exercise due diligence on Sino-Life’s business in Taiwan

Sino-Life represented in the prospectus that it intended to advance its business interest in Taiwan by undertaking the refurbishment of a columbarium. However, Sino-Life or its subsidiary did not own the columbarium. It only has an agency agreement with the manager of the columbarium that once the refurbishment work commenced, Sino-Life’s subsidiary will be given exclusive agency rights. A high risk is associated on the return on this investment when there were several encumbrances on the columbarium and a judgment has been entered against the beneficial owner of the columbarium, followed by proceedings for sale of columbarium by auction.

The auction was subsequently cancelled, but it triggered the Company to seek a legal opinion from Taiwan lawyer on the financial position of the beneficial owner of the columbarium. Even though the opinion provided was considered inadequate as it did

not address the Company's major concern, the Company acceded to Sino-Life's reinsurance on the business.

SFAT also found that the Company failed to pursue the irregularities identified and accepted such advice from the Taiwan lawyer and/or Sino-Life at face value as providing a full answer to all issues raised. It was suggested by the SFAT that the Company should have conducted further independent enquiries on the financial situation of the beneficial owner of the columbarium.

Moreover, paragraph 5.3 of the Corporate Finance Adviser Code of Conduct issued by the SFC ("**CFA Code**") provided that "[sponsor] shall use all reasonable efforts to assist its client in ensuring that the document is prepared to the required standard and no relevant information has been omitted or withheld.". SFAT found that the Company failed to disclose the various encumbrances on the asset and the risks associated in the prospectus.

3. Failure to keep proper record

There was no record of any form of meeting in the five-month period leading up to the listing. Also, there was no documentation found on the internal discussions on certain material issues, to show that the matter was given serious consideration at the time and was properly investigated.

Paragraph 2.3 of the CFA Code provided that "[a sponsor] should maintain proper books and records, and be able to provide a proper trail of work done upon request by the SFC". SFAT found that there was clear evidence of a failure on the part of the Company to maintain proper record.

Significance of the case

In the determination, SFAT emphasized the role of sponsor and its duty in making listing application. It was highlighted in the determination that sponsor should examine with professional skepticism the accuracy and completeness of statements and representations made, or other information given to it by the new applicant, its directors or any third party experts. When a sponsor engages a third party to assist with specific due diligence tasks, it remains responsible in the tasks. It should analyse the scope and extent of the tasks and assess the results of the work performed by third party and arrive at its own opinion whether the work suffice or further due diligence is required. Any irregularities identified during due diligence process should be brought to the attention of the regulators.

Conclusion

Sponsor plays an important role in bringing listing applicants to the Hong Kong market, it provides investors with information about these companies and undertakes a dual obligation towards their client and to the market. The exercise of due diligence by sponsor is important in maintaining the integrity of the market.

However, over the past few years, there have been increasing concerns about the standards of sponsors in view of the corporate scandals related to initial public offerings and sponsors' failure to carry out proper due diligence. The regulating authorities take this as a matter of considerable seriousness and have been taking various measures including implementation of the new sponsor regimes, amendments to the Rules Governing the Listing of Securities on the Exchange and guidance materials and disciplinary actions against sponsors that have failed in their duties. As of today, the gravest sanction was considered to be the one imposed on Mega Capital (Asia) Limited for acting as the sponsor for the Main Board listing of Hontex International Holdings Limited, in which Mega Capital's licence on advising corporate finance was revoked. All sponsors shall be aware of the importance of due diligence work and carry out reasonable due diligence enquiries towards the listing applications.

For enquiries, please contact our Corporate & Commercial Department:

E: cc@onc.hk
W: www.onc.hk

T: (852) 2810 1212
F: (852) 2804 6311

19th Floor, Three Exchange Square, 8 Connaught Place, Central, Hong Kong

Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

Published by **ONC** Lawyers © 2014