

Regulatory & Compliance

The SFC's most severe disciplinary actions taken against sponsors

Introduction

On 14 March 2019, the Securities and Futures Commission (“**SFC**”) reprimanded and fined UBS AG and UBS Securities Hong Kong Limited (collectively, “**UBS**”), Merrill Lynch Far East Limited (“**Merrill Lynch**”), Standard Chartered Securities (Hong Kong) Limited (“**Standard Chartered Securities**”) and Morgan Stanley Asia Limited (“**Morgan Stanley**”) a sum of HK\$375 million, HK\$128 million, HK\$59.7 million and HK\$224 million, respectively, in relation to their failures in discharging their duties as sponsors for certain listing applications on the Stock Exchange of Hong Kong (“**SEHK**”). In addition, the SFC also (1) partially suspended the licence of UBS to advise on corporate finance for one year, to the extent that UBS shall not act as a sponsor for listing application on the SEHK; and (2) suspended the licence to advise on corporate finance of the then sponsor principal of UBS for two years.

The disciplinary actions taken by the SFC against UBS, Merrill Lynch, Standard Chartered Securities and Morgan Stanley (the “**Disciplinary Actions**”) highlighted the seriousness of not conducting proper due diligence work by sponsors in listing applications.

Background

The Disciplinary Actions were mainly related to, among others, the listing applications of China Forestry Holdings Company Limited (“**China Forestry**”) and Tianhe Chemicals Group Limited (“**Tianhe**”):

1. China Forestry was listed on the Main Board of SEHK on 3 December 2009 and the trading in its shares was suspended on 26 January 2011. It was subsequently wound up and the listing of its shares was cancelled on 24 February 2017. In the listing application of China Forestry, UBS and Standard Chartered Securities were the joint sponsors (collectively, “**China Forestry Joint Sponsors**”).
2. Tianhe was listed on the Main Board of the SEHK on 20 June 2014 and the trading in its shares was suspended since 26 March 2015. In the listing application of Tianhe, UBS, Morgan Stanley and Merrill Lynch were the joint sponsors (collectively, “**Tianhe Joint Sponsors**”).

A sponsor is required to conduct adequate due diligence so as to put itself into a position to ensure that the disclosure in the listing document, primarily the prospectus, and all

information provided to the SEHK during the listing application process are true in all material respects and do not omit any material information. The SFC's investigation revealed a number of deficiencies in the due diligence work conducted by the China Forestry Joint Sponsors and the Tianhe Joint Sponsors. Notwithstanding that the exact nature, timing and extent of the due diligence work conducted by a sponsor may vary in a listing application, the SFC found that the China Forestry Joint Sponsors and the Tianhe Joint Sponsors clearly failed to conduct proper due diligence work. As highlighted below, the details of their failures can provide insights as to the standard of sponsor work that would not be acceptable to the SFC.

What has gone wrong?

China Forestry

Failure to verify the existence of forestry assets

According to the listing prospectus of China Forestry, it was a plantation forest operator whose main business were the management and sustainable development of forests and the harvesting and sale of logs, and it owned forests in the Yunnan and Sichuan Provinces of Mainland China. However, the SFC found that UBS did not conduct any site inspection of the forests. On the part of Standard Chartered Securities, although it conducted site visit, the SFC found material inconsistencies between the forest locations visited by Standard Chartered Securities as recorded in the site visit notes and the forest locations disclosed in the prospectus or the forestry right certificates, such that it was difficult to ascertain which forest locations disclosed in the prospectus Standard Chartered Securities actually visited. The China Forestry Joint Sponsors claimed that other professional parties, including lawyers and forestry experts, were involved in some of the site inspections. However, the SFC found that none of such professional parties had been instructed to verify the existence of the forestry assets as disclosed in the prospectus.

Failure to verify forestry rights

According to the listing prospectus of China Forestry, it was disclosed that China Forestry had the necessary legal rights over its forests and the relevant forestry right certificates to evidence its ownership of the trees thereupon and its rights to use the forest land. While the China Forestry Joint Sponsors claimed to have inspected the original certificates, the SFC found that the China Forestry Joint Sponsors did not identify a number of discrepancies, such as mismatch between the name of the forests as disclosed in the prospectus and as stated in the corresponding certificates. The China Forestry Joint Sponsors claimed that their Mainland Chinese lawyers had verified and checked the certificates, but they were not aware of what steps had been taken by the Mainland Chinese lawyers. Furthermore, the relevant Chinese legal opinions did not state that the certificates had been verified and checked, and

the legal opinions contained express assumptions as to the genuineness and accuracy of documents which China Forestry provided.

Failure to verify compliance with relevant forestry laws and regulations

The listing prospectus of China Forestry disclosed the means by which China Forestry undertook its logging activities in compliance with relevant forestry and environment laws and regulations. The SFC found that the China Forestry Joint Sponsors relied on written confirmations purportedly issued by the relevant forestry bureaus, which were provided by China Forestry, to confirm that the business and logging activities of China Forestry were in compliance with the relevant Mainland Chinese forestry laws. However, there is no evidence that the China Forestry Joint Sponsors had verified whether those written confirmations were issued by the relevant forestry bureaus and that the information recorded therein was accurate. The China Forestry Joint Sponsors claimed that they relied on their Mainland Chinese lawyers' due diligence on the written confirmations, but the SFC found no evidence that they had requested the Mainland Chinese lawyers to check or verify the authenticity of the written confirmations.

Inadequate due diligence on the insurance coverage

Having sufficient insurance coverage for China Forestry's forestry assets was of fundamental importance to China Forestry's business. However, the SFC found that the China Forestry Joint Sponsors relied on the insurance documents provided by China Forestry as evidence of such insurance coverage without independently verifying the authenticity of the insurance documents. Although the China Forestry Joint Sponsors claimed that they and their Mainland Chinese lawyers had reviewed the insurance documents, they did not identify a number of issues, such as inconsistencies between the locations of certain forests as stated in the insurance documents and as disclosed in the prospectus. When the SFC made inquiries with the insurer which had allegedly insured all the forests of China Forestry, the insurer confirmed that none of the insurance contracts provided by China Forestry to the China Forestry Joint Sponsors was issued by it.

Inadequate due diligence on customers

It was disclosed in the listing prospectus of China Forestry that approximately 70.5% and 81.4% of China Forestry's revenue was generated from customers located in Yunnan for the year ended 31 December 2008 and the six months ended 30 June 2009, respectively. The SFC found that the China Forestry Joint Sponsors only conducted telephone interviews with customers in Yunnan but not face-to-face interviews due to an earthquake in Yunnan back then. In the absence of further due diligence work, this means that the China Forestry Joint Sponsors were not able to verify the existence of those customers and the identity of their representatives at their place of business. In addition, the SFC found that the China Forestry

Joint Sponsors arranged the telephone interviews by calling either the fixed line or mobile number provided by China Forestry, and there is no evidence that they took any steps to verify the customer's telephone number and/or the identity of the individual to be interviewed.

Tianhe

The Tianhe Joint Sponsors also made similar mistakes in conducting due diligence on customers as in the case of the China Forestry Joint Sponsors described above. Further, the SFC found that the interview questions asked by the Tianhe Joint Sponsors during certain interviews with Tianhe's customers were unclear, and thus led to unclear answers.

In relation to a particular customer interview, while the Tianhe Joint Sponsors requested to conduct face-to-face due diligence interview with the largest customer of Tianhe, Customer X, at its business premises, the Tianhe Joint Sponsors eventually agreed to interview Customer X at Tianhe's office, after Tianhe informed them that Customer X was a large state-owned enterprise and would normally turn down any third party request to visit its premise because of an anti-corruption campaign in Mainland China. At the end of the interview, the representative of Customer X refused to produce his identity and business cards and stormed out of the meeting. The SFC found that notwithstanding such unusual incident, the Tianhe Joint Sponsors did not conduct any follow-up inquiries to ascertain that the person they interviewed was an authorised representative of Customer X and that he had the appropriate authority and knowledge for the interview.

Lessons learnt

Due diligence is an extensive exercise which requires professional skepticism and judgement. The SFC's findings illustrated that mere reliance on the documents and representations from the listing applicant without conducting independent verification cannot meet the standard required for sponsors to discharge their responsibility on due diligence. In addition, sponsors are expected to raise further inquiries whenever red flags are raised during the due diligence process. Had the China Forestry Joint Sponsors and the Tianhe Joint Sponsors conducted their due diligence work more diligently, a number of issues in the listing applications of China Forestry and Tianhe would have been identified. As a result of the substandard due diligence work, not only do the China Forestry Joint Sponsors and the Tianhe Joint Sponsors but also the investors of China Forestry and Tianhe have to pay the price.

Conclusion

The Disciplinary Actions reinforced the SFC's position that sponsors play a very important role as the "gate-keeper" in listing applications. When sponsors perform substandard due diligence work, companies not suitable for listing would nevertheless be listed. Their failure may cause enormous loss to public investors and jeopardise the investors' confidence in the integrity of the Hong Kong financial markets.

For enquiries, please contact our Litigation & Dispute Resolution Department:

E: regcom@onc.hk

T: (852) 2810 1212

W: www.onc.hk

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 © 2019