

Corporate Finance

Latest regulatory action on sponsor failure

Introduction

On 16 September 2020, the Securities and Futures Commission (the “**SFC**”) announced that it has prohibited a former responsible officer (“**RO**”) of Yi Shun Da Capital Limited (“**YSD Capital**”), who was also its chief executive officer, from re-entering the industry for 20 months for breaching the (1) *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (the “**Code of Conduct**”), and (2) *Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers*. He was a sponsor principal in charge of the supervision of the execution of a listing application in 2017 for which YSD Capital was the sponsor.

What went wrong?

In the SFC’s disciplinary action, the SFC found that the former RO failed to discharge his duties as a sponsor principal, an RO and a member of the senior management of YSD Capital as he had failed to (1) exercise due skill, care and diligence in handling the listing application; (2) diligently supervise his subordinates to carry out the sponsor work undertaken by YSD Capital; and (3) ensure the maintenance of appropriate standards of conduct by YSD Capital.

The SFC has not disclosed any further information about the above disciplinary action as it is related to another disciplinary action against YSD Capital for the same listing application and YSD Capital has made an application to the Securities and Futures Appeals Tribunal (the “**Tribunal**”) for a review of the disciplinary action against it.

According to a decision of the Tribunal dated 6 July 2020, the SFC found that YSD Capital was culpable of misconduct in its conduct of the listing application of Imperial Sierra Group Holdings Limited (“**Imperial Sierra**”) and that it was not a fit and proper person to remain licensed. YSD Capital was therefore reprimanded and fined HK\$4.5 million. In relation to this SFC decision, YSD Capital has also applied for a review of the disciplinary action against it in the Tribunal.

Common compliance issues of IPO sponsors

The SFC has repeatedly reminded sponsors to avoid five big failings as follows.

Adopting a box-ticking approach

A common failing is sponsors' failure to consider the extent of the due diligence required, and resorting to a box-ticking approach. It is important for sponsors to develop comprehensive due diligence plans customised for the applicant's unique business model at the start of each engagement instead of relying on a generic checklist. Sponsors should devote sufficient time for each engagement to ensure that all major issues are being dealt with properly.

Ignoring red flags

Another common failing is sponsors' failure to take reasonable steps to follow up on obvious red flags. Sponsors have to verify that the business operations are accurately described in the listing application. For instance, if 90% of a listing applicant's revenue is derived from sales to a group of customers, and this is mainly paid through third-party payers, the sponsor should regard it as an obvious red flag and follow up to establish the authenticity of the sales.

Improper interview practices

The SFC noted that some sponsors failed to comply with the requirements for sponsors' interview practices set out in paragraph 17.6 of the Code of Conduct, such as failing to verify the identity of the interviewees independently and that the interviewees had the appropriate authority and knowledge. Sponsors should follow up on questions which were not satisfactorily answered during the interviews. Sponsors should also spend sufficient time to properly consider the issues raised in the interviews and resolve the potential red flags accordingly.

Over-reliance on experts and third parties

Sponsors are reminded to critically review an expert's opinion and conduct necessary follow-up to resolve any material discrepancies, irregularities or inconsistencies. For instance, a sponsor should look into and disclose to the regulators a material difference between the figures provided by two auditors. The fact that the auditors have audited the listing applicant's accounts would not relieve the sponsors of their responsibility to assess the listing applicant's financial and business performance.

Sponsors are also responsible for tasks undertaken by third parties. A sponsor should be able to explain why it can rely on the third party considering its qualification and competence, whether it communicates the scope and extent of the due diligence to the third party, and whether the third party's work provides a sufficient basis to determine that reasonable due diligence has been conducted and hence the sponsor's due diligence obligations have been discharged.

Improper supervision and inadequate resources

The SFC found that sponsor principals in some cases might not have the capacity to adequately supervise the transaction teams, resulting in failing to escalate critical matters.

Following the implementation of the SFC's Manager-In-Charge regime in 2017, management responsibility is now a particular focus in the SFC's inspections. Sponsor principals should adequately supervise their transaction teams at all times, attend key due diligence interviews together with junior team members so as to be better informed about the listing applicants, and provide timely guidance to the team when needed.

Conclusion

The SFC imposed fines of over HK\$800 million in disciplinary actions against sponsor firms in 2019 alone. It also suspended the licences of several sponsor firms as well as sponsor principals. These serve as a strong message to sponsors that the SFC has little tolerance for any misconduct and will be resolute in upholding conduct standards in IPO listing applications. Hence it is very important for sponsor firms and sponsor principals to understand and comply with the relevant regulatory regime and seek appropriate legal advice where necessary.

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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.

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